

April 21st, 2017

Farmer Bros. Co. (FARM)

Alec Odnoha

Sector: Consumer Staples

Industry: Food Products

Current Price: \$35.30

Target Price: \$43.17

Farmer Bros. Co. is a national coffee roaster, wholesaler, and distributor of coffee, tea, and culinary products. Some of their robust product line includes roast and ground coffee, frozen liquid coffee, flavored and unflavored iced and hot teas, and cappuccinos to name a few. Farmer Bros. also engages in the selling of culinary products, such as gelatins, puddings, soup bases, mixes, jellies, and preserves. The business operates under one segment and sells its products mainly under the Farmer Brothers, Artisan Collection by Farmer Brothers, Superior, and Metropolitan brands. Farmer Bros. services range from small restaurants and foodservice operators to large buyers, such as restaurant chains, hotels, casinos, and gourmet coffee houses. Products are available through direct-to-consumer sales through the company website, or by third-party distributors or common carriers. The company was founded in 1912, and is currently in the process of developing a new headquarters in Northlake, Texas.

BUY

Current Price: \$35.30

Target Price: \$43.17

Market Cap: 593.9M

52 Week Range: \$26.69 - \$37.55

Ke: 10.83%

ROIC (LTM): 88.23%

D/E: 1.35

Net Income Margin (LTM): 16.52

Catalysts:

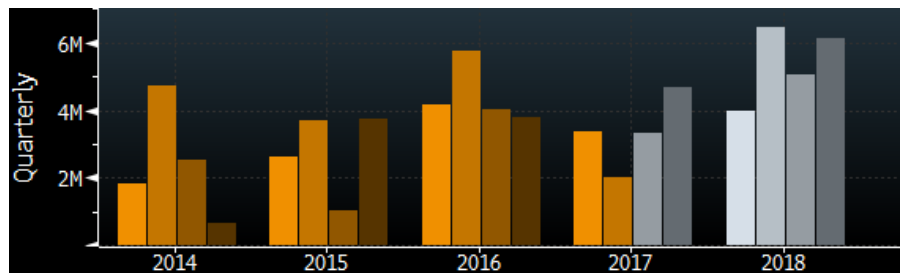
- Short Term(within the year): Corporate relocation, development of new products, coffee consumption/demand
- Mid Term(1-2 years): Strategic acquisitions, warehouse management, evaluation of cost structure, investment in HR
- Long Term(3+): Strategic investment in assets, sustainability across operations



Thesis: Farmer Brothers has been a staple in the coffee industry for a number of years. The business is founded on the value of service for others, and that tradition is still upheld with the desire to provide high-quality products to customers of all markets, such as foodservice, hospitality, and healthcare to name a few. The company's service record has historically resulted in an expanding customer base. Widespread presence in the coffee industry is growing. Product diversification and variety is expanding, and the company is currently in the process of a relocation in order to better its competitive advantage within the market. Despite incurring heavy costs and some distractions, the company still saw marginal expansion and performed well financially. Considering these factors, the national increase in coffee consumption, and an experienced management team, Farmer Brothers is well positioned to maintain its place as a stronghold in the specialty coffee industry and make a statement towards greater market share.

Q2 2017 Earnings Performance: Despite experiencing some distractions and setbacks, Farmer Bros. still performed well and experienced positive momentum in Q2 2017. The company's coffee volume increased 5.7%, which made it the fourth consecutive quarter with volume growth in the mid-single digits. As a result, the company processed and sold 24.5 million pounds of green coffee, compared to 23.2 million in the prior year period, resulting in more sales. Gross profit increased 4.1% to \$55.1 million, compared to 52.9 million

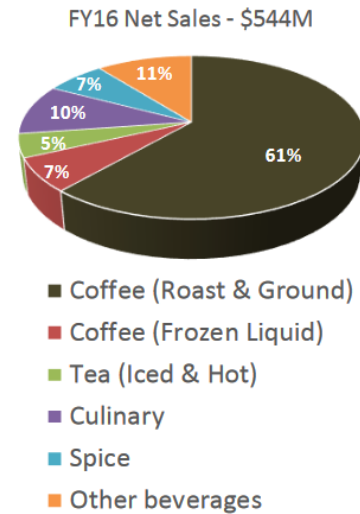
in the prior year period. Net income for the quarter totaled \$20.1 million, which is significantly higher in comparison to last year, mostly attributed to a gain on the sale of the company's former Torrance facility of \$37.4 million, which will be explained later. Nonetheless, adjusted net income per quarter, not taking into



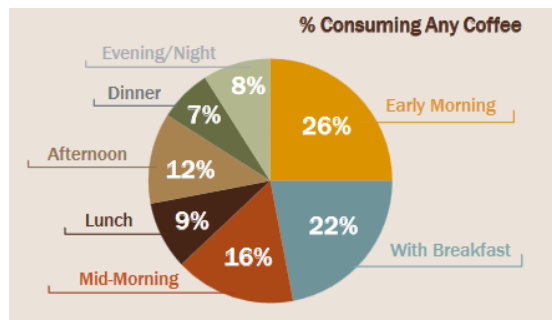
Source: Bloomberg

account the gain on sale, is projected to rise in the coming quarters as shown in the visual. The reasons due to the fluctuations in total net income is primarily due to the company relocation project currently underway. Restructuring, and transition expenses are down \$1.3 million compared to last year, due to the near completion of the relocation. Management holds a firm belief that Q3 coming up will be the last with significant expenses. Overall net sales for the quarter were down 2.3% from prior year, totaling \$139 million. This can be attributed due to the overall decrease in net sales of spice and coffee products, however, this loss can be partially offset by an increase in net sales of tea. Spice sales decreases could be attributed to the sale of the company's institutional spice business to Harris Spice Company, finalized in December of 2015. Operating expenses were down considerably, at \$19.2 million versus \$47.5 million in prior year. Recognition of the gain on sale for the Torrance facility and lower restructuring expenses in connection with the relocation plan were the forces behind such a decline. Operating income for the company also saw a sharp increase, totaling \$35.9 million in comparison to \$5.4 million in Q2 of 2016. Again, the reason for such a gain was in part due to the Torrance sale. It may be tough to believe in the financial performance of the company due to the inflation of this sale, both in revenue and expenses. However, the company does have a track record of success, a loyal customer base, and has still output positive performance in the midst of large company setbacks. As a result, I expect continued growth of the company, both in terms of company plans and as a result of the growing coffee market moving forward.

Products and Services: Farmer Brother's credits their product variety as one of the key drivers behind their business. The company offers a robust product line that varies in both type and make. Varieties include: roast coffee, ground coffee, frozen coffee, iced and hot tea, spices, and culinary products, such as gelatins, puddings, soup bases, and dressings for example. On top of that, the company has a platform for top-notch service, over a multitude of tiers, specifically value, premium, and specialty. These allow for a wide number of options for consumers, and are factors in a proven track record with customer retention. Farmer Brothers is recognized as one of the most complete (local, regional, and national) DSD networks in the coffee industry. For their overall net sales, Roast and Ground coffee takes up the majority of their sales, at around 61% total, as displayed in the visual. For the industry as a whole, specialty coffee is forecasted to grow roughly 6%, and iced coffee beverages are projected to



Source: Investor Presentation



grow roughly 9%. Overall coffee consumption is increasing as well; coffee is no longer viewed as just a "morning" drink. Farmer Brother's multiple tier services and options coupled with an expanding and already vast product line allow for an idealized sell with customers. With a strong recognition in the industry and certain sectors projecting growth, as well as increases in coffee volume, the company is certainly in a good spot in terms of increasing their stronghold on the coffee industry.

Acquisitions: Acquisitions are a large portion of the company's way of business, especially over the last few years. Most recently in the last few months, the company completed two acquisitions that are expected to be of huge value to them, namely China Mist Brands, Inc. and West Coast Coffee. China Mist was acquired in October of 2016, for a total of \$11.2 million. China Mist is expected to be a large catalyst for the company in expanding its hold on the premium tea market. China Mist is a strong tea brand, and will add to Farmer Bros. economy of scale and service, with China Mist performing national distribution in over 20,000 foodservice locations. West Coast Coffee is also slated to have a large impact on the value of the company, and for Farmer Bros. most profitable product. West Coast Coffee was acquired in February of this year, for a total of \$13.5 million. West Coast is a Portland-based coffee-manufacturer and distributor, primarily focused on convenience store, grocery, and foodservice channels. As a result, the customer base is expected to expand even further and new market opportunity is more within reach. West Coast maintained distribution to over 2,000 locations, and helps in broadening the company's reach to the Northwest of the country. For FY 2017, the company has plans to continually expand their product line, while utilizing opportunistic M&A activities. These two acquisitions will not only create growth in their bottom



line and expand their scale, but will surely allow for greater exposure over more markets and with more customers, that will stimulate growth.

Corporate Relocation: One of the cornerstone movements behind Farmer Brother's business plan is the relocation of the company's headquarters that is currently underway. Having started in 2015, the company has relocated to Northlake, TX, from their former headquarters in Torrance, CA. The company felt that the move would make the company much more competitive, and would better position itself to capitalize on the growth opportunities set in place as of now. The company incurred cash costs of \$30.5 million upon the start of the project. A majority of those costs can be contributed to SG&A, roughly \$17 million, with the remaining portion also in connection with the overall transition, in restructuring costs and other expenses. The company produced an estimate of the overall construction costs totaling around \$55-\$60 million, and IT, equipment, and other related costs totaling \$35-39 million. This project as a whole has displayed both positives and negatives for the company. For example, the project as a whole can be attributed to increases in CAPEX, but Q3 of this year is slated to be the last quarter of significant expenses. Seeing that a majority of costs and expenses are one-time and non-recurring, the company does not foresee an increasing level of debt. The relocation plan is also projected to produce cost savings of roughly \$18-20 million, annually, which is huge. From the Torrance facility, the company realized a gain of \$37.4 million, which is a testament to the reasoning for such a high net income for the quarter. However, net income is still projected to continually increase, both quarterly and annually, upon project completion. The company credits this move with a continual building of a solid foundation for future growth, and positions them nicely to capitalize on competitive opportunities. With this in knowledge, it is important to recognize how the company is still able to display positive performance in the wake of a sizeable project with heavy costs. The company is taking any action they can to collectively reduce costs and create value in penetration of new market opportunities. Coffee remains an exciting and ever-changing area, with product possibilities and consumption demand constantly changing. This move is ideal for the company in developing future growth, and can point towards seeing a higher EBITDA margin in the future, as a result of consolidation of multiple facilities into one. Long-term, this relocation project will reduce operating and other expenses whilst generating value in presenting better opportunity for the company to expand.

Financial Performance: Reviewing the quarterly performance results indicated that the company is certainly headed in the right direction for FY 2017. That runs with consistent with the company's continued positive performance year-over-year, and so there are a few factors I would like to outline. For FY 2016, net income totaled \$89.9 million, compared to \$700,000 for FY 2015, which also resulted in a rapid EPS increase. At year end, the company had \$21.1 million in cash and equivalents, and also \$25.6 million in short-term investments, compared to \$109,000 outstanding on the company's revolving credit facility. This facility for the company has a \$75 million borrowing capacity, and so at year end it is indicative of the company's low debt and solvency. CAPEX totaled \$31 million, an increase from \$19 million in FY 2015. However, these costs can be attributed to brewing equipment, facility improvements, and relocation costs related to the company's corporate relocation project. The corporate relocation costs, totaling \$4 million, should be one-time and non-recurring, and so with construction slated to end in Q3 of 2017, and the consolidation of multiple facilities, CAPEX can be expected to decrease. D&A expense for the

FARMS Marginal Snapshot				
12 Months Ending	FY 2013	FY 2014	FY 2015	FY 2016
Gross Margin	36.04	37.08	36.09	38.3
EBITDA Margin	6.41	6.86	5.03	5.32
Operating Margin	0.01	1.69	0.6	1.5
Net Income Margin	-1.65	2.3	0.12	16.52

year totaled \$20.8 million, down from \$24.2 million the previous year. For the year, the company also held fixed price contract commitments for green coffee orders, totaling \$62.5 million, a \$21.5 million increase from 2015. Despite some setbacks in terms of construction for relocation, the company was still able to exhibit positive performance. Looking at 1-year marginal growth, as shown in the above visual the company saw in operating margins, gross margins, net income margins, and EBITDA margins. The slight decreases in each margin in FY 2015 can be attributed to the beginning of the corporate relocation project. Projections also have the completion of the new corporate building saving \$18-20 million annually, which can lessen expenses even more and can enable the company to either re-invest for growth or higher payouts for shareholders. Initiatives are in place currently to expand revenue growth even more, with the completed acquisitions as referred to earlier in the article. Revenue growth and decreasing expenses are two of the main focuses in the company's business plan and overall guidance. As indicated by Q2 2017 results, the company is on the right track in successfully doing so, and creating value.

Conclusion: Farmer Brother's management team seems to have a clear vision as to what they want to accomplish as a company. Plans are set in place to extend the company's reach and influence in the coffee industry. Recognized by some of the most accredited associations in the industry, the company is surely to uphold their values on unrivaled product quality and exception service to its vendors. With the completion of the recent acquisitions and finalizing the new corporate location, I believe the company is in a very good position to begin a strong phase of growth, with a greater arsenal and capitalization opportunities in newer markets. The company has displayed growth during some setbacks, and has also managed to cut costs. Furthermore, the market is exciting as coffee demands and consumption are constantly changing, with a variety of options available. As a result, I see this company with a considerable amount of upside, and believe they can surely reach the set one-year target price of \$43.17.

Farmer Bros. Co. (FARM)

CENTER FOR GLOBAL FINANCIAL STUDIES

BULLISH

Analysis by Alec Odnova

4/23/2017

Current Price:

\$35.20

Divident Yield:

0.7%

Intrinsic Value:

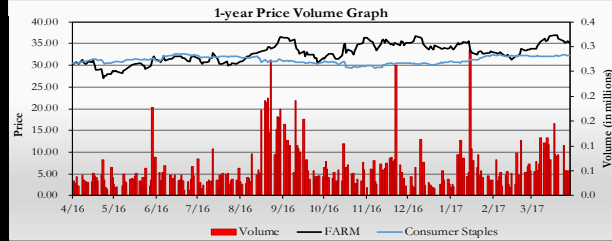
\$115.08

Target Price:

\$133.66

Target 1 year Return: 280.39%

Probability of Price Increase: 100%

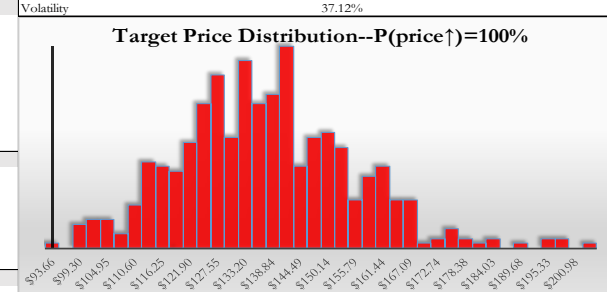


Description	Farmer Bros.
Sector	Consumer Staples
Industry	Food Products
Last Guidance	November 3, 2015
Next earnings date	May 6, 2017
Estimated Country	6.25%
Risk Premium	40%
Effective Tax rate	-20%
Effective Operating Tax rate	-20%

Market Data	Farmer Bros.
Market Capitalization	\$583.36
Daily volume (mil)	0.05
Shares outstanding (mil)	16.57
Diluted shares outstanding (mil)	16.76
% shares held by institutions	74%
% shares held by investments Managers	36%
% shares held by hedge funds	12%
% shares held by insiders	51.88%
Short interest	3.21%
Days to cover short interest	8.66
52 week high	\$37.55
52-week low	\$26.69
Levered Beta	1.05
Volatility	37.12%

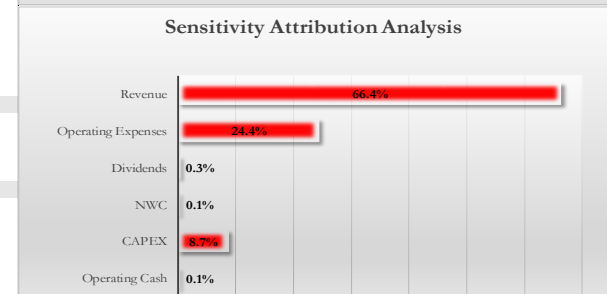
Quarter ending	Revenue	EBITDA
12/31/2015	-3.65%	-23.33%
3/31/2016	-1.85%	-28.82%
6/30/2016	-1.35%	-42.54%
9/30/2016	-5.44%	-37.90%
12/31/2016	-4.22%	-29.73%
Mean	-3.30%	-32.46%
Standard error	0.8%	3.4%

General Information	Peers
Consumer Staples	Inteventure Foods, Inc.
Food Products	Lancaster Colony Corporation
November 3, 2015	Coffee Holding Co., Inc.
May 6, 2017	J&J Snack Foods Corp.
6.25%	McCormick & Company, Incorporated
40%	B&G Foods, Inc.
-20%	Post Holdings, Inc.
-20%	National Beverage Corp.



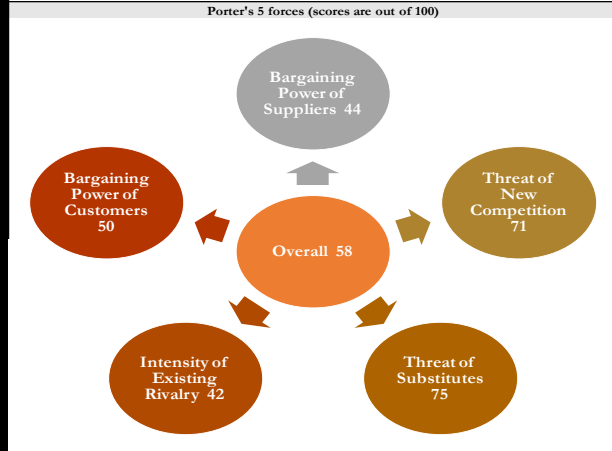
Management	Position	Total compensations growth	Total return to shareholders
Keown, Michael	Chief Executive Officer, Pre	27.46% per annum over 5y	15.07% per annum over 5y
Matti, Thomas	General Counsel and Assistan	68.27% per annum over 2y	24.97% per annum over 2y
Bisby, Scott	Senior Vice President and Ge	109.31% per annum over 2y	24.97% per annum over 2y
Robson, David	Chief Financial Officer and	N/M	N/M
Iobst, Ellen	Chief Operations Officer	N/M	N/M
Siers, Scott	Senior Vice President and Ge	N/M	N/M

Profitability	FARM (LTM)	FARM (5 years historical average)	Industry (LTM)
ROIC	36.6%	-23.92%	11.37%
NOPAT Margin	8%	-2.17%	9.4%
Revenue/Invested Capital	4.81	11.05	1.21
ROE	22.0%	-17.14%	13.34%
Adjusted net margin	7%	-2.54%	8.2%
Revenue/ Adjusted Book Value	3.04	6.76	1.62



Invested Funds	FARM (LTM)	FARM (5 years historical average)	Industry (LTM)
Total Cash/Total Capital	17.9%	22.7%	10%
Estimated Operating Cash/Total Capital	4.4%	5.7%	N/A
Non-cash working Capital/Total Capital	16.9%	28.3%	4%
Invested Capital/Total Capital	80.6%	80.0%	87%
Capital Structure	FARM (LTM)	FARM (5 years historical average)	Industry (LTM)
Total Debt/Common Equity (LTM)	-0.02	-0.02	0.22
Cost of Existing Debt	-13.21%	-0.46%	3.96%
Estimated Cost of new Borrowing	15.25%	15.25%	3.96%
CGFS Risk Rating	F	F	CC
Unlevered Beta (LTM)	1.10	1.37	0.54
WACC	11.95%	13.04%	6.98%

Porter's 5 forces (scores are out of 100)	Period	Revenue growth	Valuation	ROIC/WACC
	Base Year	-0.5%	7.6%	3.06
	12/31/2017	2.4%	6.7%	2.12
	12/31/2018	2.5%	8.1%	2.79
	12/31/2019	2.7%	8.9%	3.17
	12/31/2020	2.9%	10.2%	4.39
	12/31/2021	3.0%	11.3%	5.45
	12/31/2022	3.2%	12.3%	6.70
	12/31/2023	3.4%	13.4%	8.16
	12/31/2024	3.6%	14.5%	9.86
	12/31/2025	3.7%	15.5%	11.84
	12/31/2026	3.9%	16.5%	14.16
	Continuing Period	4.1%	17.5%	16.88
	Period	Invested Capital	Net Claims	Price per share
	Base Year	\$125.44	-\$28.54	\$65.68
	12/31/2017	\$126.99	-\$55.45	\$71.64
	12/31/2018	\$134.14	-\$80.52	\$78.04
	12/31/2019	\$99.31	-\$125.96	\$84.64
	12/31/2020	\$111.83	-\$163.79	\$91.50
	12/31/2021	\$155.98	-\$208.81	\$98.60
	12/31/2022	\$145.36	-\$255.32	\$105.92
	12/31/2023	\$144.15	-\$306.05	\$113.48
	12/31/2024	\$122.59	-\$361.66	\$121.27
	12/31/2025	\$112.75	-\$422.68	\$129.26
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